

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

NO FURTHER SUBSTANTIATION
Release copies to Director

Date [REDACTED]
Surname [REDACTED]

Date: JUL 5 2000

Contact Person: [REDACTED]
ID Number: [REDACTED]
Telephone Number: [REDACTED]

000

Employer Identification Number: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

Your primary purpose is to operate a Montessori school that was previously owned and operated by your founders, [REDACTED] and [REDACTED] under the name [REDACTED] as a subchapter S corporation. A subchapter S corporation enjoys the corporate characteristics of limited liability and perpetual duration but is taxed as a sole proprietorship. [REDACTED] are the sole shareholders of [REDACTED]. The S corporation has amended its Charter to delete operating the school as one of its corporate purposes. You have submitted a balance sheet listing as assets of [REDACTED] the buildings, furniture and fixtures you are using for the school and have indicated that the land is owned by [REDACTED]. On [REDACTED], [REDACTED] as sole incorporator, filed your Articles of Incorporation in the State of [REDACTED]. Your school is now doing business as [REDACTED].

You state that you rent the land, buildings and fixtures used in your operations from [REDACTED]. The Commercial lease you submitted shows [REDACTED] as the lessors. You have submitted an appraisal from [REDACTED] of [REDACTED] stating that the fair market rental value for this property is \$[REDACTED] per square foot or \$[REDACTED] per year. You have executed a lease in the amount of \$[REDACTED] annually from [REDACTED] until [REDACTED]. At that time, if you continue to occupy the property, the lease continues on a month to month basis and the rent escalates to [REDACTED] times the current monthly rent, or \$[REDACTED] annually. This property is listed as an asset of [REDACTED] and is valued at \$[REDACTED] on its balance sheet.

[REDACTED] is the Chairman of your board of directors. The other directors are [REDACTED] President, [REDACTED] Treasurer, [REDACTED] Treasurer, [REDACTED] Headmistress, and [REDACTED] Academic Director. [REDACTED] is employed as the Office Administrator of the school and receives \$[REDACTED] a year for her services. [REDACTED] is the Headmistress and receives \$[REDACTED] a year for her services in that capacity. [REDACTED] receives \$28,000 compensation for her services as the Academic Director. According to your by-laws, your board of directors is elected by your membership. Your initial members were [REDACTED] who appear to have appointed the board.

This is in keeping with Article V of your Charter which lists [REDACTED] as your initial directors and indicates that you are to be controlled by the directors, not the members.

You are supported primarily by tuition payments from enrolled students. You also may receive grants, donations and receipts from various fund-raising activities. You offer some financial aid. Your policy on financial aid is to use it to keep current students enrolled when their families experience economic stress rather than make your school more affordable to new families. To this end, you offer a few needy students temporary tuition reduction, loans or scholarships each year. No subsidy exceeds 50% of the tuition. Faculty children may receive financial aid.

The information you submitted in Exhibit G indicates that you have a total of [REDACTED] students enrolled. The [REDACTED] Directory shows a total of [REDACTED] students enrolled. [REDACTED] children are enrolled students. Each of your other board members also have children enrolled in your program. It is not clear whether any of your board members receive financial aid on behalf of their children or whether tuition is part of the compensation package offered to your employees.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

Section 170(b)(1)(A)(ii) of the Code defines a school as an educational organization, which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides that the term "educational", as used in section 501(c)(3), relates to—

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 179, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973). Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

In P.L.L. Scholarship v. Commissioner, 82 T.C. (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there was separate accounting and no payments were going to the bar. The Court was not persuaded.

A realistic look at the operations of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements does not change that fact.

The Court went on to conclude that the organization had a substantial nonexempt purpose.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that another gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place. The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view.

Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994, indicates otherwise.

The Court concluded that K.J.'s Fundraisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interests.

In reaching a negative conclusion in Redlands Surgical Services, v. Commissioner, 113 T.C. 47 (1999), the Tax Court also closely examined the structure of the relationships among the parties and stated:

Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purpose in engaging in it. An organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes." Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), aff'd. T.C. Memo. 1990-84. ...

The court also looked closely at the governing arrangement of the partnership. It likened it to a board of directors. The court stated that the composition of the board of directors gives an indication of whether the organization is operated for public or private purposes. The court quoted with approval from Income Tax Exempt of the Contemporary Nonprofit Hospital, Mancino, 32 St. Louis U.L.J. 1015, 1051 (1988).

The board of directors, its composition, and its functions are relevant to tax exemption...the composition of the board provides important evidence that the hospital serves public rather than private purposes. For, example, it is fair to presume that a board of directors chosen from the community would place the interests of the community above those of either the management or the medical staff of the hospital. Thus, the relevance of the board is that its process should indicate whether the hospital is operated for the benefit of the community or to secure benefits for private interests.

The importance of the "control" issue is also illustrated in Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980). The Church was controlled completely by one family, the Herberts. The Herberts family completely controlled the Church's operations and as the only voting members were able to perpetuate that control. The Court made the following statement concerning the effect of this total control.

Preliminarily we note that petitioner, at all pertinent times, was completely dominated by the Herberts family—a father, mother, and son. Because they were the only voting members and they composed the board of directors, the Herberts were in a position to perpetuate this control of petitioner's operations and activities indefinitely. Petitioner had no affiliation with any denomination or ecclesiastical body and, therefore, the Herberts family was not subject to any outside interference or influence in the control of petitioner's affairs. This means that the Herberts, without challenge, could dictate petitioner's program and operation, prepare its budget, and spend its fund, and could continue to do so indefinitely.

The Court of Appeals, in Bubbling Well Church of Universal Love, Inc. v. Commissioner, 670 F. 2d 104 (1981) affirmed the decision of the Tax Court.

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefitted financially from

the conversion. The ruling concludes that private interests were served. The conclusion is stated as follows:

The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, (the applicant) is not operated exclusively for educational and charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). Because your primary activity is the presentation of formal instruction in a school setting as defined in section 170(b)(1)(A)(ii) of the Code, you satisfy the organizational requirements.

You must, however, also satisfy the operational test. The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement is that an organization be operated exclusively for one or more exempt purposes. To determine whether this test is satisfied, section 1.501(c)(3)-1(c)(1) of the regulations directs the Service to determine if the organization engages primarily in activities which accomplish one or more exempt purposes. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes unless it serves a public rather than a private interest. Based on the facts that you have provided in your application for recognition of exemption, we are not able to conclude that you are operated exclusively for public rather than private purposes.

[REDACTED], your founding parents, initially created the school to afford their four children the benefits of a Montessori program. The school was operated as a sole proprietorship under subchapter S of the Internal Revenue Code. In spinning off the school function to you, it is notable that none of the assets previously owned or used by the school were transferred to you. You continue to lease both the facility and the furnishings from [REDACTED]. In addition, [REDACTED] remain firmly in control of your operations. They selected and serve on the board of directors in addition to [REDACTED] holding a salaried position. In this regard, the influence [REDACTED] maintain over your operations is similar to the control exercised by the bar owners in P.L.L. Scholarship v. Commissioner, supra, and K's Fund Raisers, Inc. v. Commissioner, supra, and by the Herberts family in Bubbling Well Church of Universal Love, Inc. v. Commissioner. They remain free to set policy for their own benefit without objective scrutiny from an independent board of directors. They have entered into a contract for the lease of your premises that is not at arms-length. Although the operation of a school is a charitable activity, the manner in which you operate leads us to conclude that your school bestows significant private benefit on [REDACTED] and their for-profit corporation, [REDACTED].

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you

[REDACTED]

want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll-free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
[REDACTED], T:EO:RA:T:4, Rm. 6232
1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) G. V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

[REDACTED] [REDACTED]